BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**FORMAL OPINION**
	2006-SBE-002
APPLE COMPUTER, INC.	Case No. 152016

Representing the Parties:

For Appellant: Christopher Whitney
Barry Weissman

For Respondent: John Su, Tax Counsel III

Counsel for the Board of Equalization: Ian C. Foster, Tax Counsel

I. Introduction

This appeal is made pursuant to section 19045[1], of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Apple Computer, Inc. against a proposed assessment of additional franchise tax in the amount of $1,258,506 for the year ended September 30, 1989.[2] The issue presented in this appeal is the proper treatment of dividends received from controlled foreign corporations that are partially included in appellant's water's-edge combined report.

For the reasons set forth in this opinion, we conclude that to the extent dividends are paid from the issuing corporation's accumulated earnings, they are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings,

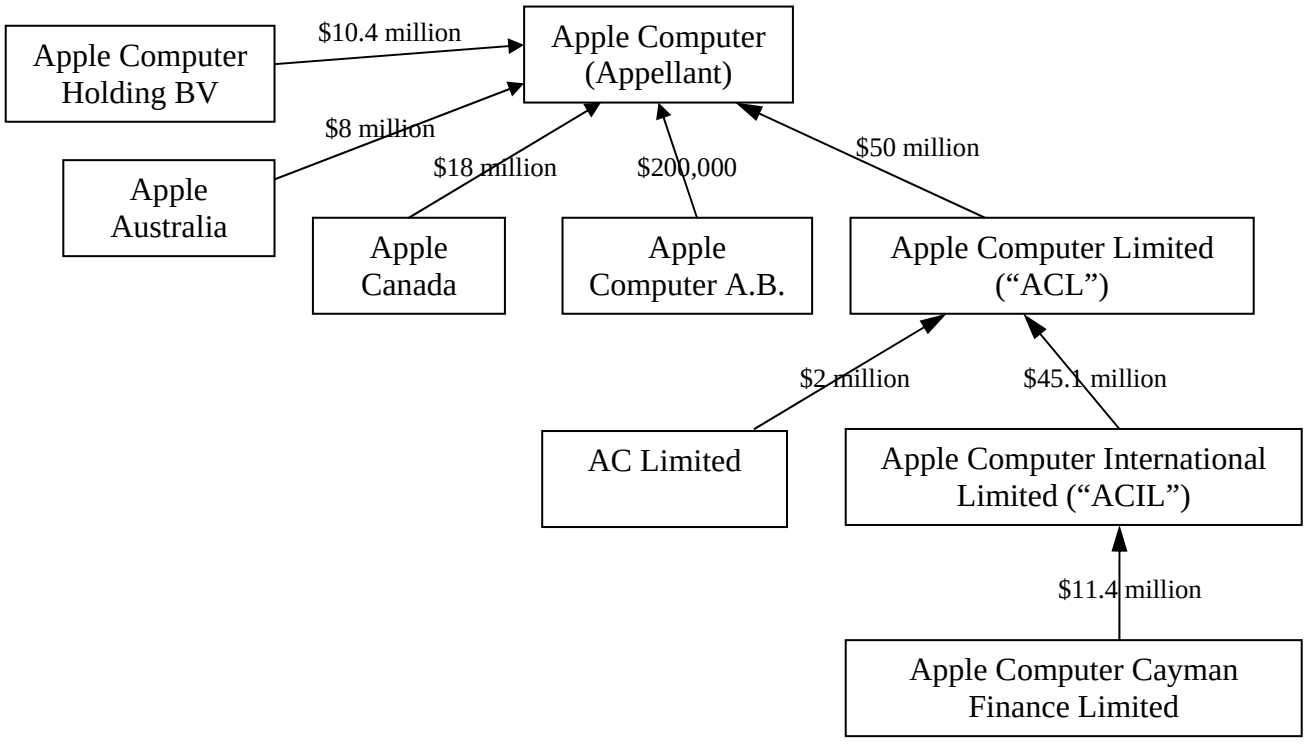
[1] Unless otherwise specified, all references to a "section" or "sections" are to sections of the Revenue and Taxation Code, and all references to a "regulation" or "regulations" are to title 18 of the California Code of Regulations.

[2] $1,258,506 was the amount at issue when appellant initially filed this appeal. The parties have since resolved most of the original issues and the amount at issue is reduced to $231,038.

exhausting each year's earnings in turn. We further conclude that to the extent dividends are paid from a year in which the issuing corporation is partially included in the water's-edge combined report, they are deemed paid from "included income" and "excluded income" in the ratio that included and excluded income bear to total income. (See definitions of "included income" and "excluded income," at footnote 3, *infra*.)

II. Factual and Procedural Background

Appellant is a domestic corporation headquartered in Cupertino, California, that develops, manufactures, and sells personal computers and software to a variety of customers in the United States and abroad. Appellant has several wholly-owned foreign subsidiaries from which it received dividends. The parties agree that each relevant subsidiary is a controlled foreign corporation ("CFC") for purposes of Internal Revenue Code ("IRC") sections 951 through 964 ("Subpart F"). The following chart illustrates the corporate relationships and the amounts of dividends paid from and between appellant's subsidiaries:



Through the year ended September 30, 1988, appellant had filed its California returns on a worldwide combined reporting basis. Beginning with the year ended September 30, 1989,

appellant elected to file its California returns on a water's-edge basis. Under the water's-edge rules, appellant's CFC's were required to be partially included in the combined report based on their ratios of Subpart F income to total earnings and profits. Appellant determined that the dividends received by ACL and ACIL were not Subpart F income and they should be excluded from the numerator of those companies' inclusion ratios. The result was to include a relatively smaller portion of ACL and ACIL in the water's-edge combined report. Appellant also treated the dividends that it received as paid from income that was included in the combined report, to the extent of that income, and any excess as being paid from income that was excluded from the combined report.[3] The result was to eliminate the dividends received from partially included foreign subsidiaries from appellant's income.

Upon audit, respondent determined that the dividends received by ACL and ACIL were Subpart F income and they should be added to the numerator of those companies' inclusion ratios. Respondent also determined that the dividends received by appellant should be treated as being paid from the current year's earnings first and the most recent years' earnings thereafter; then, dividends paid from any given year should be deemed paid in part from included income and in part from excluded income on a prorated basis. Respondent's adjustments resulted in a larger portion of ACL and ACIL being included in the water's-edge combined report and a smaller portion of the dividends received by appellant being eliminated from income. Accordingly, respondent issued a Notice of Proposed Assessment ("NPA") proposing additional tax due of $1,875,442. Appellant protested the NPA and, upon further review, respondent reduced the assessment (for reasons not relevant here), then affirmed an amount of $1,258,506. Appellant then filed this timely appeal.

This appeal was deferred for approximately three years pending the outcome of litigation that both parties agreed was highly relevant and possibly controlling. That litigation was resolved when the Court of Appeals issued an opinion in *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459 ("*Fujitsu*").[4] As relevant here, *Fujitsu* held that dividends received by an upper-tier

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[3] Hereinafter, we will refer to income that was included in the water's edge combined report as "included income." Likewise, we will refer to income that was excluded from the water's edge combined report as "excluded income."

[4] Amdahl Corporation commenced the litigation, then later changed its name to Fujitsu IT Holdings. In the opinion, the court referred to the taxpayer as Amdahl, as it was known during the years at issue.

foreign subsidiary from a lower-tier foreign subsidiary are not Subpart F income and, therefore, such dividends should be excluded from the inclusion ratio. (*Id.*, at p. 478.) Pursuant to that holding, respondent concedes that dividends received by ACL and ACIL should be excluded from the numerator of those companies' inclusion ratios. Also as relevant here, *Fujitsu* held that dividends paid to a domestic parent from a partially included foreign subsidiary's current earnings should be treated as being paid first out of income that was included in the combined report, with any excess being paid from excluded income. (*Id.*, at p. 480.) In this case, however, respondent continues to maintain that dividends should be prorated between included and excluded income.

III. The Underlying Statutory Framework

In order to aid in the understanding of the issues in this appeal, as well as our resolution of those issues, we believe it is useful to review the underlying statutory framework.

A corporation that is engaged in a unitary business generally must determine its California tax liability based upon a worldwide combined report that includes the income and apportionment factors of all members of the unitary group, wherever located. (Rev. & Tax. Code, §§ 25101 & 25120 – 25137.) However, a corporation may elect to file a water's-edge combined report that includes only those entities that are incorporated in the United States and other specified entities with sufficient connections to the United States. (Rev. & Tax. Code, § 25110.)

If a taxpayer files a water's-edge combined report, the report must include a CFC that has Subpart F income. (Rev. & Tax. Code, § 25110, subd. (a)(7).)[5] California incorporates the federal definitions of a "controlled foreign corporation" and "Subpart F income." (Rev. & Tax. Code, § 25110, subd. (a)(7); Int.Rev. Code, §§ 951 - 964.) The "Subpart F" provisions in the Internal Revenue Code were enacted "to deter taxpayers from using foreign subsidiary corporations to accumulate earnings in countries that impose no taxes on accumulated earnings" and the provisions thereby "eliminate the tax deferral benefits of the undistributed income earned by the CFC." (*R.E. Dietz Corp. v. United States* (2nd Cir. 1991) 939 F.2d 1, 6.) Likewise, California requires the inclusion of a CFC with Subpart F

[5] During the year at issue, the provision requiring partial inclusion of a CFC with Subpart F income was located in subdivision (a)(7) of section 25110. That provision is now located in subdivision (a)(6) and remains substantially unchanged.

income, which otherwise would have escaped taxation in a foreign country, in the water's-edge combined report. (*Fujitsu, supra*, 120 Cal.App.4th at p. 469.)

A CFC with Subpart F income is not included in its entirety in the water's-edge combined report, but rather is included only to the extent that its business activity results in Subpart F income. To this end, the CFC's income and apportionment factors are multiplied by an "inclusion ratio," the numerator of which is the CFC's Subpart F income and the denominator of which is the CFC's total earnings and profits. (Rev. & Tax. Code, § 25110, subd. (a)(7).)

Section 25106 provides that dividends paid from one member of a unitary group to another member of the group are eliminated from the recipient's income if the dividends are paid from income that was already included in the combined report. Section 24402, as relevant here, provides a 100 percent deduction for dividends that are paid from income that was subject to California tax (regardless of whether the issuing corporation is a member of the recipient's unitary group). Section 24411, as relevant here, provides a 75 percent deduction for dividends that are paid by a member of the recipient's water's-edge group if those dividends are not otherwise eliminated or deducted under sections 25106 or 24402.

As indicated above, the instant appeal involves dividends paid by CFC's that are partially included in appellant's water's-edge combined report. Such dividends were paid from income that had accumulated over several years and that was, in the water's-edge year, partially included in the combined report. To the extent those dividends were paid from included income, they are subject to complete elimination under section 25106, and to the extent those dividends were paid from excluded income, they are subject to the 75 percent deduction under section 24411. However, after this appeal was filed, the Court of Appeals struck down section 24402 as unconstitutional because it facially discriminates against corporations that are not doing business in California. (*Farmer Bros. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976 ["*Farmer Bros.*"].) Respondent's forward-looking remedy is to no longer enforce the unconstitutional statute; that is, respondent no longer allows any deduction under section 24402.[6] (Rev. & Tax. Code, § 19393.) Respondent's backward-looking remedy is to allow the

[6] The forward-looking remedy applies to tax years ending on or after December 1, 1999, as those years were still open to assessment at the time of the *Farmer Bros.* decision. (See Rev. & Tax. Code, § 19057.)

section 24402 deduction for dividends received in earlier years, regardless of whether the dividend-issuing corporation was doing business in California. (Cf. *Ceridian Corp. v. Franchise Tax Board* (2000), 85 Cal.App.4th 875, 888-889.) In this way, no taxpayer is advantaged or disadvantaged by the *Farmer Bros.* decision. Respondent's backward-looking relief, applied here, was to allow section 24402 deductions for dividends received from appellant's foreign subsidiaries. Therefore, in light of *Farmer Bros.*, the dividends that appellant received from its partially included CFC's are, to the extent paid from included income, eliminated under section 25106, and, to the extent paid from excluded income, deducted under section 24402.

In this case we are faced with dividends paid from earnings that had accumulated over several years, some of which were worldwide combined reporting years, but the most recent of which was a water's-edge combined reporting year. Our task is to determine how to allocate dividends among the various years and, when allocated to a water's-edge reporting year, how to allocate the dividends among included and excluded income.[7]

IV. Last-In-First-Out Ordering

The parties appear to agree that the relevant law requires last-in-first-out ("LIFO") ordering with respect to dividends paid from accumulated earnings. They disagree on the mechanics of applying LIFO ordering in practice.

A. Applicable Law

Except as otherwise provided, California generally incorporates the provisions of IRC section 316. (Rev. & Tax. Code, § 24451.) IRC section 316(a) provides that dividends paid from accumulated earnings are deemed paid from the most recently accumulated earnings. Congress enacted LIFO ordering to deter abuse by preventing the issuing corporation from declaring what year's earnings

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[7] At first glance, sections 25106 and 24402 seem to have a distinction without a difference; in effect, they both ensure that the entire dividend is excluded from the recipient's taxable income. However, the material difference arises in the context of section 24425, which disallows deductions for expenses that are allocable to items of income that are not included in the measure of tax. The California Supreme Court has determined that section 24425 disallows expenses allocable to dividends deducted under section 24402. (*Great Western Finanical Corp. v. Franchise Tax Board* (1971) 4 Cal.3d 1.) Section 24425 does not apply to expenses that are allocable to dividends eliminated by section 25106. Therefore, appellant may not deduct expenses allocable to dividends deducted under section 24402, while it may deduct expenses allocable to dividends eliminated under section 25106.

were being distributed. (*Edwards v. Douglas* (1925) 269 U.S. 204, 216.) During the year at issue, regulation 24411, subdivision (i)(2)(A), set forth the following rule with respect to dividends received from a partially included CFC:[8]

> "Dividends shall be considered to be paid out of current earnings and profits to the extent thereof and from the most recently accumulated earning and profits thereafter."

The plain language of both IRC section 316(a) and regulation 24411 require LIFO ordering. However, the parties disagree on the mechanics of LIFO ordering.

B. Contentions

Appellant contends that LIFO ordering is satisfied by allocating dividends to the current year's included income to the extent thereof, then to the most recent year's included income, and so on, until all of the accumulated included income is exhausted. Then, any excess dividends can be allocated to excluded income in the same manner. Appellant argues that its interpretation of LIFO ordering is required by *Fujitsu* and section 25106. Appellant notes that the *Fujitsu* court did not simply require that dividends be deemed paid first from included income; the court also emphasized that the plain language and purpose of section 25106 allows members of a unitary group to move dividends among themselves without taxation, and stated that only its method of allocating dividends would effectuate that purpose. (*Fujitsu*, 120 Cal.App.4th at pp. 477-480.)

Respondent contends that LIFO ordering is satisfied only by allocating dividends in such a way that exhausts each year's earnings in turn, without regard to whether the income is included or excluded. Respondent contends that its interpretation is required by the plain language of IRC section 316(a) and regulation 24411.

C. Discussion

We agree with respondent's interpretation of LIFO ordering. IRC section 316(a) and regulation 24411 do not differentiate between different kinds of income; they state that dividends are deemed distributed from more recent earnings before older earnings, without regard to whether the underlying income is included or excluded. Appellant's interpretation does the opposite, deeming

[8] The relevant language in regulation 24411 is now found in subdivisions (e)(1) and (e)(2)(B).

dividends distributed from included income first, without regard to the year in which the income was earned. In so doing, appellant's interpretation would render meaningless the statutory and regulatory references to "current" and "most recent" earnings.

Appellant's reliance on *Fujitsu* is misplaced because that court did discuss LIFO ordering. In fact, in its holding on allocating dividends, the court stated:

> "We conclude that dividends paid by first-tier subsidiaries from current year earnings should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) any excess paid out of earnings eligible for partial deduction under section 24411." (*Fujitsu*, 120 Cal.App.4th at p. 480 [emphasis added].)

The court's holding expressly applies to dividends paid "from current year earnings." The court made no mention of how to treat accumulated earnings. Accordingly, *Fujitsu* does not provide any guidance on LIFO ordering and does not support appellant's position. Appellant's reliance on section 25106 is also misplaced. Section 25106 merely provides that dividends paid from included income are eliminated from the recipient's income, but it does not address the method for determining whether dividends are paid from included income in the first place. Moreover, appellant's interpretation of LIFO ordering would defeat the original purpose of LIFO, which is to prevent the corporation from choosing which year's earnings it wants to distribute for tax purposes.

For the foregoing reasons, we conclude that IRC section 316(a) and regulation 24411 require LIFO ordering with respect to dividends paid from accumulated earnings. We further conclude that, in order to comply with LIFO ordering, the dividends are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings, exhausting each year's earnings in turn, without regard to whether the earnings represent included or excluded income.

V. Preferential Ordering vs. Prorating

After the application of LIFO ordering determines what portion of the dividends are paid from any given year's earnings, the issue becomes the allocation of dividends paid from a year in which the underlying income was partially included in the combined report. There are two competing methods for determining whether dividends received from a partially included CFC are paid out of included

income, excluded income, or some combination thereof. For the sake of consistency and ease of reference, we will refer to those methods as "preferential ordering" and "prorating."

Preferential ordering (advocated by appellant) would deem the dividends to be paid first from included income, to the extent thereof, and any excess to be paid from excluded income. Prorating (advocated by respondent) would deem the dividends to be paid in part from included income and in part from excluded income, in the ratio that included and excluded income bear to total income. Preferential ordering would subject a greater portion of the dividends to complete elimination under section 25106, while prorating would subject a greater portion of the dividends to deduction under sections 24402 or 24411.

A. Applicable Law

Where dividends are paid from income with a mixed character, such as income that is partially sourced in California or partially included in a combined report, respondent's consistent administrative practice since the 1940's has been the use of prorating. In 1958, respondent issued Legal Ruling 211 and promulgated regulation 24402, both of which require prorating. In 1970, the California Supreme Court endorsed respondent's use of prorating in *Safeway Stores v. Franchise Tax Board* (1970) 3 Cal.3rd 745 ("*Safeway*"). In 1989, respondent promulgated regulation 24411, which contained a clear requirement for prorating in subdivision (i)(2)(B):

> "(B) Dividends which are considered paid out of earnings of a year in which a portion of the dividend-paying entity's income and factors were considered in determining the amount of income derived from or attributable to California sources of another entity shall be considered subject to the provisions of Sections 24402, 24410, and 25106 of the Revenue and Taxation Code based upon the ratio of the income included by reference to [the CFC inclusion ratio] to the total earnings and profits … of the entity for the year." (Emphasis added.)[9]

Regulation 24411 also contained examples, in subdivision (i)(4), that applied prorating to hypothetical fact patterns.[10]

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[9] The above-quoted version of regulation 24411 is the version applicable to the year at issue in this appeal. The current version of the relevant language is now found in subdivision (e)(2)(B).

[10] The relevant examples in regulation 24411 are now found in subdivision (e)(4).

In 2004, *Fujitsu* became the first authority to require preferential ordering. The *Fujitsu* court agreed that regulation 24411 requires prorating, but it construed an example in regulation 25106.5-1, subdivision (f)(2), as requiring preferential ordering.[11] Perceiving a conflict in the regulations, the court stated that there was an "absence of clear and controlling guidance" and that it would construe the regulations in favor of the taxpayer and in harmony with the underlying statutes. (*Fujitsu IT Holdings, supra*, 120 Cal.App.4th at p. 480.) The court then held that dividends should be deemed paid "first out of earnings eligible for elimination under section 25106," i.e., included income, with "any excess paid out of earnings eligible for partial deduction under section 24411," i.e., excluded income. (*Id.*)

B. Contentions

Appellant contends that *Fujitsu* is controlling authority and, therefore, the dividends paid by appellant's CFC's should be deemed paid first out of earnings that were included in the combined report and eliminated from income under section 25106. Appellant points out that this appeal was deferred at the request of both parties to await a decision in *Fujitsu* and that respondent repeatedly acknowledged the possible controlling effect of *Fujitsu*.

Appellant argues that *Fujitsu* was not based merely on regulatory interpretation, but also relied on section 25106 and the legislative intent embodied therein. Appellant emphasizes the court's reliance on the purpose of section 25106, where it stated at page 480:

> "In the case of a CFC that is *partially* included in a unitary group, the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident only by adopting the ordering rule described above." (Italics in original.)

Appellant contends that regulation 24411, to the extent it requires prorating, is inconsistent with the statutory authority discussed in *Fujitsu*. Appellant argues that when respondent's administrative guidance is inconsistent, unsupported by statutory authority, or violates the intent of the underlying statute, the taxpayer's reasonable interpretation should be respected. According to appellant, that is exactly the position taken by the *Fujitsu* court.

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[11] We are puzzled by the *Fujitsu* court's reliance on regulation 25106.5-1. The relevant example in subdivision (f)(2) deals with LIFO ordering for dividends paid from accumulated earnings; it does not provide for the preferential ordering of dividends paid from a partial inclusion year. Moreover, subdivision (k) of that regulation clarifies that the regulation was not effective until 2001, long after the years at issue in *Fujitsu*.

Further, appellant contends that section 24411 creates a preferential ordering rule for dividends paid from mixed earnings. Section 24411, subdivision (a), allows the 75 percent deduction "to the extent not otherwise allowed as a deduction or eliminated from income." Appellant argues that the quoted language creates an ordering rule because it allows a deduction only to the extent that the dividend was not otherwise eliminated under section 25106. Appellant asserts that its interpretation of section 24411 is not only reasonable, but is the best interpretation of that section in light of its plain language and in light of the purpose of section 25106, which is to prevent double taxation of dividends.

Finally, appellant argues that regulation 24402 and *Safeway* are inapplicable because they discuss the prorating of dividends paid from income that is partially sourced to California, not income that is partially included in a combined report. Appellant argues that the enacting of section 25106 and UDITPA[12] overruled *Safeway* and created a new statutory scheme that limits the usefulness of any authority decided under the old scheme.

Respondent contends that regulation 24411 clearly requires prorating dividends when they are paid from a mix of included and excluded earnings. Respondent states that the prorating of dividends under regulation 24411 is consistent with other California law, including regulation 24402 and the California Supreme Court's endorsement of prorating in *Safeway*. Respondent states that both its approach and appellant's approach will prevent double-taxation of dividends; the difference is the timing of the deduction and the allowance of expenses.

Respondent argues that *Fujitsu* is irrelevant and therefore not controlling here. In this regard, respondent points out that *Fujitsu* discussed allocating dividends between elimination under section 25106 and deduction under section 24411. However, respondent states that the dividends at issue in this appeal must be allocated between section 25106 and section 24402. Because *Fujitsu* never discussed how the allocation works when the dividends are eligible for deduction under section 24402, respondent argues that *Fujitsu's* holding is not relevant to this appeal.

Respondent further argues that, even if *Fujitsu* is relevant, the holding in *Fujitsu* should not be followed because several components of its reasoning were erroneous. First, regulation 24411, as

[12] UDITPA is the Uniform Division of Income for Tax Purposes Act. (Rev. & Tax. Code, §§ 25120–25137.)

it read during the year at issue in this appeal (and the years at issue in *Fujitsu*) required prorating of dividends and contained examples that applied the prorating method. Second, regulation 25106.5-1, which the court cited as requiring preferential ordering, was by its own terms not applicable to the years at issue in *Fujitsu* or the year at issue in this appeal. (See footnote 11, *supra*.) Third, regulation 25106.5-1 does not in fact require preferential ordering; the example cited by the court was actually an example of LIFO ordering for dividends paid from accumulated earnings. Because of the court's erroneous reasoning, respondent asks this Board to treat *Fujitsu* with limited deference.

C. Discussion

At the outset, we are not persuaded by the parties' attempts to distinguish the authorities that do not support their respective positions. Appellant correctly states that regulation 24402 requires prorating in the context of dividends paid from income that is partially sourced to California, rather than income that is partially included in a combined report. However, both situations require the allocation of dividends paid from income that has a mixed character, and we see no theoretical reason for applying different allocation methods to substantially similar situations. Moreover, regulation 24402 requires prorating when dividends are partially subject to the section 24402 deduction, which is the case in this appeal. Appellant's attempt to distinguish *Safeway* also fails. We note the *Safeway* Court's description of the facts under its consideration at page 753:

> "[I]f the subsidiaries do business both within and without California, or have nonoperating income or other income not related to the unitary business and therefore not included in the total unitary operating income to which the formula apportionment applied, then the computation of the [predecessor to section 24402] dividend adjustment becomes more complex. When, as in the present case, the adjustments relate to a large multicorporate grocery chain which operates through a series of subsidiaries, . . . some of which do business both within and without California and have nonunitary as well as unitary income, then the computations grow quite involved." (Emphasis added.)

As the above-quoted language indicates, the dividends at issue in *Safeway* were not merely paid from income that was partially sourced to California, but also from income that was partially included in the combined report, which is the situation in this appeal. Additionally, appellant's argument that section 25106 and UDITPA overruled *Safeway*'s endorsement of prorating is not correct. Safeway had two holdings: first, there was no deduction for dividends paid from non-California-source income, even

though such income might have been included in the combined report; second, prorating was the proper method to allocate dividends among different types of income. (*Safeway, supra*, 3 Cal.3d at pp. 749-754.) Section 25106 overruled the first holding in *Safeway*, but not the second, which is the relevant holding here.[13] Likewise, any change in the business/nonbusiness character of dividends under UDITPA did not affect the rationale behind prorating. Certainly *Safeway* was decided under a prior statutory scheme, but the prorating method endorsed by the Court was not dependent upon whether, or how, any particular amount would be taxed once it was allocated to a particular type of income. Finally, we reject respondent's attempt to distinguish *Fujitsu*. The dividends in this case, to the extent not eliminated under section 25106, will be deducted under section 24402 only by virtue of the backward-looking remedy from the *Farmer Bros.* decision; were it not for *Farmer Bros.*, the dividends would be deducted under the plain language of section 24411. We do not believe the *Farmer Bros.* remedy makes the *Fujitsu* analysis any less applicable.[14]

Given our conclusion that regulation 24402, regulation 24411, *Safeway*, and *Fujitsu* are each applicable to the issue at hand, we find ourselves presented with conflicting authorities. Regulation 24402, regulation 24411, and *Safeway* all require prorating, while *Fujitsu* requires preferential ordering. After careful consideration, we hold that dividends paid from a mix of included and excluded earnings should be prorated. This holding is consistent with the weight of authority, follows the opinion of the California Supreme Court, respects longstanding administrative practice, and has a sound basis in policy and theory.

The weight of authority, including two regulations and one opinion of the California Supreme Court, points to prorating. It is important to note that *Fujitsu* never purported to invalidate regulations 24402 or 24411. As such, we are faced with two valid regulations that unambiguously

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[13] Section 25106 was actually enacted in 1967, three years prior to the decision in *Safeway*. However, section 25106 did not apply to the years at issue in *Safeway* and the Court acknowledged that its holding (regarding the elimination of dividends paid from included income) would be different under section 25106. (*Safeway, supra*, 3 Cal.3d at p. 752, fn. 7.)

[14] Appellant argues that respondent has taken an inconsistent position by attempting to distinguish *Fujitsu*, yet still apply regulation 24411. Regardless of any inconsistency in respondent's position, we are taking a consistent position here: for the reasons discussed above, we find that both *Fujitsu* and regulation 24411 are applicable.

require prorating.[15] We also note that *Safeway* was decided by a higher court than *Fujitsu*, and *Safeway* unambiguously endorsed the use of prorating. Simply put, *Fujitsu* is not the lone authority that addresses the issue at hand, but it is the lone authority to require preferential ordering. By holding that prorating is the proper method to allocate dividends between included and excluded income, we are applying two valid regulations and following the reasoning of a higher court.

Respondent's consistent, longstanding administrative practice is to prorate dividends that are paid from mixed earnings. California courts "accord significant weight and respect to a longstanding statutory construction – whether in the form of a policy or a rule – by the agency charged with enforcement of the statute." (*Ordlock v. Franchise Tax Board* (2006) 38 Cal.4th 897, 910.) Factors that weigh in favor of deference to an administrative interpretation include: the agency has expertise in a technical, complex subject matter; the agency's interpretation has been consistent; and, the agency has adopted a formal regulation embodying the agency's interpretation. (*Yamaha v. State Board of Equalization* (1998) 19 Cal.4th 1, 12-13.) The Legislature is presumed to be aware of longstanding administrative practice and its failure to enact change is evidence that the administrative practice is consistent with legislative intent. (*Id.*, at pp. 21-22 (conc. opn. of Mosk, J.), citing *Moore v. California State Bd. of Accountancy* (1992) 2 Cal.4th 999,1017-1018 and *Rizzo v. Board of Trustees* (1994) 27 Cal.App.4th 853, 862.) With respect to the present issue, the law is technical and complex, respondent has consistently applied prorating for over a half century, it has promulgated two formal regulations that embody its position, and the Legislature has not attempted to intervene. All of these factors weigh in favor of respecting respondent's longstanding administrative practice, and our holding does so.

Finally, we believe our holding is based in sound theory and policy. The reality is that the dividends at issue in this appeal are not directly traceable to either included or excluded income – they are paid from a single pool of income to which a mathematical ratio (that is unrelated to the amount

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[15] We find no merit in appellant's argument that section 24411 sets forth a preferential ordering rule that would invalidate the regulatory prorating rule. The language in section 24411 stating that a dividend is deductible thereunder "to the extent not otherwise allowed as a deduction or eliminated from income" simply ensures that a dividend is not deducted twice under two different statutes. For example, many dividends will qualify under for elimination/deduction under the plain language of both sections 25106 and 24411. The quoted language in section 24411 clarifies that, if a dividend is eligible for section 25106 elimination, then it should be eliminated from income and it is not also deductible under section 24411. Nowhere does section 24411 address the method for determining whether a dividend was paid from included income (i.e., eligible for section 25106 elimination) in the first place.

of dividends paid) is applied as a function of tax law. Prorating recognizes this reality and allocates dividends to included and excluded income in the same proportion that those types of income bear to total income. There is no practical or theoretical reason to assume that the dividends are paid primarily from included income or, for that matter, primarily from excluded income. Yet that is exactly the sort of assumption that preferential ordering requires. Preferential ordering allows the taxpayer to "have its cake and eat it, too" by receiving the benefit of excluding a portion of the subsidiary's income from the water's-edge combined report and the benefit of disproportionate section 25106 elimination. Just as LIFO ordering deters abuse by preventing the issuing corporation from declaring what year's earnings are being distributed, prorating deters abuse by preventing the issuing corporation from declaring what kind of earnings are being distributed.[16] In sum, when dividends are paid from a pool of partially included income, prorating is the most logical method for allocating those dividends among included and excluded income.

VI. Conclusion

For the reasons set forth in this opinion, we conclude that, to the extent a CFC pays dividends from accumulated earnings, those dividends are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings, exhausting each year's earnings in turn. We further conclude that, to the extent a CFC pays dividends from a year in which it is partially included in the water's-edge combined report, those dividends are deemed paid from included income and excluded income in the ratio that included and excluded income bear to total income.

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[16] We understand and share the *Fujitsu* court's concern with preventing the double taxation of included income. (See *Fujitsu*, *supra*, 120 Cal.App.4th at pp. 477 - 480.) However, we believe that preferential ordering does not simply prevent the double taxation of included income, it also allows the avoidance of taxation on excluded income. As we discussed, preferential ordering makes an assumption – that dividends are paid primarily from included income – for which there is no practical or theoretical basis, and allowing taxpayers to declare dividends as paid from included income would open the door to abuse. Prorating allocates a proportionate share of the dividends to included income, thereby preventing double taxation, and allocates a proportionate share to excluded income, thereby preventing tax avoidance. Thus, in addition to being supported by the weight of authority, prorating also satisfies the *Fujitsu* court's concern with preventing double taxation, but without the disadvantage of allowing tax avoidance.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Apple Computer, Inc. against a proposed assessment of additional franchise tax in the amount of $1,258,506 for the year ended September 30, 1989, be and the same is hereby modified to reflect the Franchise Tax Board's concessions in light of *Farmer Bros.* and *Fujitsu*, but in all other respects the action is sustained.

Done at Sacramento, California, this 20th day of November, 2006, by the State Board of Equalization, with Board Members Ms. Yee*, Mr. Leonard, and Mr. Parrish present, and with Mr. Chiang and Ms. Mandel** not participating.

_____, Chairman

* Betty Yee, Member

Bill Leonard, Member

Claude Parrish, Member

_____, Member

*Acting Board Member, 1st District

**For Steve Wesley per Government Code section 7.9.